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POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001

ANNUAL COMPLIANCE REPORT, 2012	Docket No. ACR2012

COMMENTS OF
<u>THE NATIONAL POSTAL POLICY COUNCIL</u>
(February 1, 2013)

The National Postal Policy Council ("NPPC") respectfully submits these comments on the Postal Service's Annual Compliance Report for Fiscal Year 2012 ("*ACR*"), filed December 28, 2012.

The annual compliance review process provides an opportunity for the Postal Service and Commission to recognize and begin to address some of the issues affecting First-Class Presort Mail. In particular, NPPC submits that:

– First-Class Automation and Presort Letters and Cards product once again paid a grossly excessive cost coverage and a unit contribution far in excess of that of more costly Single Piece mail.

– The Postal Service has overstated the Presort 5-Digit letter discount pass-through, the largest and most important rate category in Presort Letters, which undermines the Postal Service's goals of encouraging volume and revenue growth.

– First-Class Presort Letters and Cards satisfied applicable discount standards; and

– While NPPC supports the Postal Service's streamlining efforts, the service quality measurement reported in the *ACR* do not provide an apples-to-apples comparison on a year-to-year basis due to the reduction in service standards that occurred in Fiscal Year 2012, which may explain why large business customers continue to be the least satisfied First Class customers.

I. THE COST COVERAGE FOR THE FIRST-CLASS PRESORT LETTERS AND CARDS PRODUCT IS EXCESSIVE

In each of the past annual compliance review proceedings, NPPC has pointed out that First-Class Presort Mail has paid extremely high per-piece contributions to institutional costs and excessive cost coverages for many years. *E.g., Comments of the National Postal Policy Council*, Docket No. ACR2011 at 2-5 (February 3, 2012); *Comments of the National Postal Policy Council*, Docket No. ACR2010 at 4-5 (February 2, 2011). Unfortunately, this overpricing persisted in FY2012, with the predictable outcome that still more Presort Letter volume abandoned the postal system at a relentless pace.

The cost coverage of the Presort product in FY2012 was 292 percent (*ACR* at 8), little changed from the Postal Service's calculation of 298.8 percent in FY2011, or even the Commission's recalculation of 301.5 percent.[1] *Annual Compliance Determination, Fiscal Year 2011,* Table VII-1 (Mar. 28, 2012) ("*FY11 ACD*"). Despite this minor decline, the unit contribution from Presort mail rose to an all-time high of $0.233. *ACR* at 8.

Not only is the unit contribution paid by First-Class Presort Letters/Cards at record levels, but it continues to exceed that of Single Piece mail by 5.2 cents. *Id*. This substantially higher unit contribution of Presort Letters/Cards has persisted for a

[1] The Postal Service does not identify causes for the reduced cost coverage, although there is an unexplained increase in unit costs of 0.5 cents.

great many years, despite that the average Presort cost of 12.1 cents per piece is considerably less than half of the 27.5 cent cost per piece of Single Piece letters.

In light of this perpetual overpricing of the Presort product, no one should be surprised that Presort volumes continued to erode. FY2012 witnessed the Postal Service deliver some 1.58 billion fewer pieces of Presort mail than in FY2011, a year-over-year volume decline of 3.8 percent. This was approximately the same rate of decline as in FY2011, indicating that the Postal Service continues steadily to lose Presort volume. As the Postal Service said last year, because the First-Class Presort product is the Postal Service's most profitable and largest product, these "continued presort volume declines create significant financial concerns." *FY2011 ACR* at 17. Yet volumes fell yet again.

NPPC is pessimistic that the Postal Service will stem this decline in Presort volume as long as it continues annually to give the largest percentage rate increases to 5-Digit Presort letters. It really should come as no surprise that charging the largest volume product excessive rates year after year results in steadily hemorrhaging volumes year after year. While NPPC members appreciate steps the Postal Service has taken at the margins – such as the "second-ounce-free" rate for Presort letters – the Postal Service must address the prices paid by most of the product.

The persistently excessive rates for 5-Digit and other tiers in the Presort Letter product stem directly from the notion that Presort mail (more than 40 billion pieces) is somehow nothing but a workshared derivative of the substantially smaller (23 billion pieces) Single Piece product. This "linking" regime that is now under review in the

Court of Appeals. If the Court reverses that decision, as it should, then the Postal Service would be free to set both Single Piece and Presort prices on the basis of their own demands and costs, which could only help postal finances. If the Court leaves "linking" in place, the Postal Service should, as the Commission has twice suggested, establish without further delay a new benchmark rate in Single Piece mail and set Presort discounts on the basis of that more realistic benchmark.

Simply repeating past pricing practices will not lead to different results. The Postal Service is unlikely to stem the volume losses as long as it continues to raise core Presort rates generally, and the 5-Digit rate in particular, by above-average amounts. NPPC submits that the Postal Service should consider the much different approach of smaller increases, or even reductions, in Presort prices, instead of gouging its most important customers as it has in recent years.

II. THE POSTAL SERVICE HAS OVERSTATED THE DISCOUNT PASS-THROUGH FOR FIRST-CLASS PRESORT 5-DIGIT LETTERS, MASKING HOW MUCH SUCH LETTERS ARE OVERCHARGED

The Postal Service presents the workshare discount pass-through for 5-Digit letters as 96 percent (*ACR*, USPS-FY12-3 - FY 2012 Discounts and Passthroughs of Workshare Items, Tab FCM Bulk Letters, Cards). This overstates the pass-through as seen by mailers in the market. The true pass-through facing mailers is 77.4 percent. That is the percentage by which the 5-Digit price passes through the total costs avoided between AADC letters and 5-Digit letters, which is the relevant measure because the Postal Service effectively eliminated the 3-Digit discount in FY2012.

The Commission is currently conducting a rulemaking that would improve its reporting requirements in recognition of this new relationship between the AADC and 5-Digit tiers. *Notice of Proposed Rulemaking on Analytical Principle Used in Periodic Reporting (Pitney Bowes Inc. Proposal One)*, Docket No. RM2012-6 (October 23, 2012). Although the Postal Service's presentation of the pass-through may be technically correct because this rulemaking has not been completed, it does not accurately reflect the pricing signals facing mailers.

If one looks at the AADC and 5-Digit discounts as seen by mailers in the real world, it becomes apparent that the pass-through of the 5-Digit rate, in particular, sends woefully inefficient pricing signals and results in excessive prices. The 5-Digit Presort letter price may be the single most important price in the entire rate schedule, as Presort Letters/Cards is the largest revenue product and 5-Digit letters comprise the largest volume in that product. One would expect that the Postal Service would price that product as attractively as possible to encourage its use, but such has not been the case. In fact, at times the Postal Service has seemingly been more concerned with the difference between the 5-Digit price and the Single Piece price[2] than with the differences between the Presort price tiers actually facing real-world mailers. Presenting a pass-through percentage based on a non-existent 3-Digit rate, instead of the AADC rate, merely masks the pricing error and results in excessive, inefficient rates.

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[2] *See United States Postal Service Notice of Market-Dominant Price Adjustment*, Docket No. R2013-1, at 50 (October 11, 2012).

NPPC respectfully urges the Postal Service and Commission to use accurate measures of discount pass-throughs as a step towards long-delayed but necessary rate relief to Presort rates generally, and the 5-Digit rate specifically.

III. THE POSTAL SERVICE'S WORKSHARING DISCOUNTS COMPLY WITH STATUTORY REQUIREMENTS

The Postal Service identifies five First Class Presort worksharing discounts in effect in FY12 – Mixed AADC Automation Letters, AADC Automation Letters, Automation Mixed AADC Postcards, Automation ADC Flats, and 5-Digit Automation Flats -- that exceed the costs that it recently estimated were avoided during that year. The Commission should find those discounts in compliance with the statute.

In addition, the Commission should focus attention on why the calculated costs avoided fluctuate widely from year to year. Business mailers, no less than the Postal Service, face considerable whip-sawing in the costs avoided estimates, and those costs avoided eventually lead to corresponding price changes that can undermine business planning.

Mixed AADC Automation Letter Discount

The *ACR* reports that the Mixed AADC Automation Letter pass-through in FY2012 was 102.2 percent. That is based on a comparison of the discounts that were in effect throughout FY12 -- of 5 cents and 4.6 cents – to a year-end retrospective estimate of costs avoided of 4.5 cents. *ACR* at 10. In perspective, the discount was extremely close to estimated avoided costs and smaller than the difference between year-end discounts and unit cost avoided that the Commission calculated in the FY2011 ACD (Table VII-2). As the Postal Service notes, the discount that just took effect on January 27 passed through less than the then-current estimate of costs avoided. *ACR* at 10-11.

Nonetheless, the estimated costs avoided in recent years have see-sawed widely, from 3.4 cents at the end of FY11 to 5.9 cents in October 2012 to the most recent estimate, in the *ACR*, of 4.5 cents. These unexplained fluctuations in estimated costs avoided should give the Commission pause before placing much confidence in the current 4.5 cent estimate, much less in any presumption that the avoided costs in FY 2013 will remain near that level. Given the importance of the Mixed AADC discount in the Presort discount tree, the Commission should examine these cost estimates carefully.

The Postal Service's approach of taking these considerations into account in pricing over time, especially while the cost estimates change wildly and the very idea that the Mixed AADC discount should be linked at all to Single Piece rates, is appropriate and satisfies Section 3622(e)(2)(D). It should be approved.

AADC Automation Letter Discount

The Postal Service reports that the AADC Automation Letter pass-through in FY2012 was, at 115.4 percent, slightly more than 100 percent. *ACR* at 11. Here too, NPPC is concerned about a lack of stability in the estimates of costs avoided. In fact, this pass-through proved to be much less than the 142.9 percent that the Postal Service had expected when it set the AADC price in October 2011.[3]

The issue in this proceeding is whether postal rates in FY2012 complied with statutory requirements. Given that the actual pass-through proved to be much smaller than the Postal Service had originally thought (and which the Commission approved at that time), the Postal Service's approach to managing workshare discounts deserves approval now as well. In addition, the new AADC discount from the Mixed AADC rate of 2.1 cents equals the Commission's calculation of FY11 avoided costs,[4] and passes through much less than 100 percent of the *ACR*'s estimate of avoided costs (2.6 cents).

Mixed AADC Automation Postcards

The Postal Service reports that the Mixed AADC Automation Cards pass-through in FY2012 was 227.3 percent. *ACR* at 11. This is remarkable, because when the Postal Service established that discount level in October 2011, it set it at 92.6 percent of the then-most recent estimate of costs avoided.[5]

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3 *See United States Postal Service Notice of Market-Dominant Price Adjustment*, Attachment B, Tab Workshare Discounts and Benchmarks--First-Class Mail Bulk Letters and Postcards (Oct. 18, 2011) ("USPS R2012-3 Notice").

4 *ACD*, Table VII-2.

5 *See USPS R2012-3 Notice, Attachment B*, Tab Workshare Discounts and Benchmarks--First-Class Mail Bulk Letters and Postcards (Oct. 18, 2011).

What changed between October 2011 and December 2012 was not the discount, which remained constant at 2.5 cents throughout the year, but the estimated costs avoided, which shrunk dramatically over a short period of time. Estimated avoided costs have fallen from 2.7 cents in FY10, to 1.9 cents in FY11 (*ACD*, Table VII-3), to 1.1 cents in FY12. *ACR* at 11.

On balance, the Postal Service has done remarkably well in adjusting discount levels in response to reductions in avoided costs while avoiding rate shock and disrupting mailer operations. For unexplained reasons, however, those cost estimates are changing by unexpected amounts. A change of 1.6 cents (more than 50 percent of the estimated avoided costs) in the cost estimates in two years requires further examination before sound conclusions can be drawn. A cautious approach is especially required where there is an enormous potential for rate shock.[6]

The Commission in November approved the reduction to the current discount at the time knowing that it was above the then-current estimate of avoided costs,[7] and should not disturb that decision now. However, the Commission could usefully explore why the estimate of costs avoided has declined so abruptly in so short a time.

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[6] When the Postal Service announced the reduction of the Mixed Automation Cards discount to 2.3 cents, it noted that any further reduction would cause rate shock throughout the Postcard presort tree, and has since elaborated on the potential rate shocks in its response to Chairman's Information Request No. 3, Question 1, in this proceeding.

[7] *Order on Price Adjustments for Market Dominant Products and Related Mail Classification Changes*, at 22 (Nov. 16, 2012) (Order No. 1541).

Automation ADC Flats

The Postal Service reports that the Automation ADC flats pass-through in FY2012 was 158.7 percent. *ACR* at 12. As in the case of Mixed Automation Cards, this pass-through is far less than the percentage pass-through of 227.3 percent that the Postal Service contemplated when setting that discount in October 2011.[8] At that time, the Postal Service explained that the above-100 percent pass-through was a consequence of a change in costing methodology adopted in RM2008-2.[9] The Commission approved that discount at the time, and can hardly object when the pass-through proved to be less than anticipated. The Postal Service has been reducing that pass-through steadily for several years, in a manner cognizant of rate shock, and the Commission should continue to approve its approach.

5-Digit Automation Flats

The Postal Service reports that the 5-Digit Automation Flats pass-through in FY2012 was 131.5 percent. *ACR* at 12. In FY11, the 5-Digit Automation Flats pass-through was only 92.6 percent. *FY11 ACD*, Table VII-2.

The change from FY11 to FY12 has not been due to the discount, but to a large change to estimated costs avoided. It appears that the avoided costs estimate has unexpectedly shrunk by 4.5 cents (from 18.8 cents to 14.3 cents) in only one year. NPPC has not found an explanation of this dramatic change on this record.

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[8] *See USPS R2012-3 Notice*, Attachment B, Tab Workshare Discounts and Benchmarks--First-Class Mail Bulk Letters and Postcards.

[9] *USPS R2012-3 Notice* at 36.

In the R2013-1 price adjustments, the Postal Service set the now-current discount equal to the then-most recent estimate of avoided costs.[10] The course of FY13 will tell whether that 4.5 cent drop in estimated avoided costs was an aberration or reflects some permanent operational change.

IV. LARGE BUSINESS CUSTOMERS REMAIN THE LEAST SATISFIED WITH FIRST CLASS PRODUCTS

The *ACR* reports both service quality performance and customer satisfaction. Both report commendable performance, but NPPC notes that the Commission should weigh these measures carefully. In particular, while NPPC generally supports the Postal Service's network streamlining and other cost-reduction initiatives as necessary responses to the current business environment in which it operates, it is important to bear in mind that those changes may have affected both measurements. It is also important to remember that service quality reductions should affect the price cap as well.

First, the Postal Service boasts that it met its target for service quality for both the Single Piece and Presort Letters/Cards products in FY12. *See ACR, Library Reference USPS–FY12-29* at 4. On its face, that is commendable. However, the Commission should assess this reported performance cautiously.

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[10] In addition, the Postal Service also gave a substantial price increase to the heavier weight flats that dominate the volume in that category. As NPPC noted at the time, the Postal Service's price increases for heavy 5-Digit Automation flats exceed 10 percent by the 4 ounce weight increment and reach 15 percent at 13 ounces.

The Postal Service adjusted its service standards downwards during FY12 when it implemented the first phase of network realignment. (Indeed, for that reason, it adjusted the EXFC methodology for measuring service quality in the fourth quarter. *See id.*, at 7). Consequently, the service quality performance reported in the *ACR* for FY12 does not provide an apples-to-applies comparison to the service provided in FY11, because the standards differed between those two years. Thus, the *ACR* does not clearly illuminate whether service quality in fact improved or the goalposts merely changed. And the Postal Service plans to reduce service standards further until January 2014, so a consistent comparison may not be possible for several years.

This is not a trivial point. Whenever it seeks to reduce (or "realign") service standards, the Postal Service has taken the position that customers care more about service consistency than speed. That is a convenient argument to make whenever the Postal Service proposes to reduce the speed of delivery by shrinking overnight and two-day delivery areas.

But it is not entirely correct. Many large commercial mailers require *speedy* delivery – in addition to consistent -- as well in order to satisfy regulatory obligations to provide timely notice, to manage invoices, statements, and payments, and generally to conduct business throughout the nation in the 21st century. NPPC members care both about consistency *and* speed of delivery.[11]

[11] In its post-hearing comments in the network rationalization proceeding, NPPC stated "if the Postal Service is unable to maintain even the lessened service that the revised standards would dictate, it will serve only to compound its problems by driving away still more volume." *Comments of the*

Thus, perhaps it is not surprising that the *ACR* reports that large businesses are less satisfied with market dominant products than are either residential or small business customers. In particular, large business's satisfaction with First Class Mail decreased nearly a full percentage point. *ACR* at 36. In contrast, residential customers may place a lower premium on speed of delivery, and small businesses may have a larger focus on service on a local or regional basis.

Finally, the Commission should address the implications of the Postal Service's reduced service standards on the rate cap for First Class Mail.[12] The Postal Service did not address the effects of degraded service on the cap in the *ACR*, as it has little incentive to raise the issue, but as the network rationalization process continues those implications will need to be addressed.

National Postal Policy Council and the Major Mailers Association, Docket No. N2012-1, at 6 (July 10, 2012)

[12] *Id*. at 7.

V. CONCLUSION

The National Postal Policy Council respectfully urges the Commission to take these Comments into consideration in making its Determination, and to find that First Class Presort rates are consistent with statutory requirements.

Respectfully submitted,

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